OFFICIAL TRANSCRIPT

PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: UNITED STATES, Petitioner v. JERRY W. CARLTON

CASE NO: No. 92-1941

PLACE: Washington, D.C.

DATE: Monday, February 28, 1994

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IN THE SUPREME COURT OF THE UNITED STATES

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UNITED STATES :

Petitioner :

v. : No. 92-1941

JERRY W. CARLTON :

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Washington, D.C.

Monday, February 28, 1994

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 2:02 p.m.

APPEARANCES:

KENT L. JONES, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Petitioner.

RUSSELL G. ALLEN, ESQ., Newport Beach, California; on behalf of the Respondent.

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P R O C E E D I N G S

(2:02 p.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument now in Number 92-1941, the United States v. Jerry W. Carlton. Mr. Jones.

ORAL ARGUMENT OF KENT L. JONES

ON BEHALF OF THE PETITIONER

MR. JONES: Mr. Chief Justice, and may it please the Court:

This case concerns whether Congress may promptly and retroactively correct a palpable drafting defect in tax legislation. Respondent is the executor of Willametta Day, who died in September 1985. One year after her death, Congress enacted the 900-page-long Tax Reform Act of 1986. One provision of that complex act, codified at section 2057 of the Internal Revenue Code, established a new estate tax deduction in the amount of one-half of an estate's sale of stock to the corporate issuer's employee stock ownership plan, or ESOP.

Respondent sought to take advantage of this new deduction by purchasing $11 million of the stock of MCI Corporation in December 1986, which was 15 months after Mrs. Day died. He sold the stock two days later to the MCI ESOP at a somewhat lower price. He claimed an $11 million estate tax deduction under section 2057 -- I'm

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sorry, he claimed a $5-and-a-half-million estate tax deduction under section 2057 for half of the value of the proceeds of the sale. The claimed deduction resulted in a $2-and-a-half-million estate tax savings.

Now, applied as Respondent did in this case, section 2057 would permit the executor of any estate to entirely eliminate its estate tax obligation simply by purchasing and reselling corporate securities after the decedent's death. As contemporary financial commentators noted, this application of the statute would, and I quote, "be the tax loophole you could drive a truck through."

Congress obviously did not intend in 1986 to eliminate the Federal estate tax. But recognizing that section 2057, interpreted in this manner, could have that effect, the Internal Revenue Service promptly proposed an amendment to the statute --

QUESTION: Was there any other manner to interpret it? I mean, you said that Congress made a mistake, but didn't the words mean what they appear to mean? There was no requirement that the decedent own the stock at the time Congress enacted this measure?

MR. JONES: We concede that it was a drafting defect in the sense that, as the retroactive amendment provided, that by its terms, the statute should have been limited to the sales of stock that were directly owned by

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the decedent at the time of death. So, yes, we do concede that the statute should have been more explicit.

The question that we have in this case is whether by making it explicit for the brief retroactive period of one year --

QUESTION: Mr. Jones, do you have many cases like this pending?

MR. JONES: There are I believe three other -- if cases like this you are talking about cases under section 2057 -- I believe there are three other cases, out of the thousands of estate tax returns that were filed during this period, three other instances where executors sought to take what we would regard as this aggressive interpretation of the statute.

QUESTION: Do you think it was a mistake in interpretation of the statute?

MR. JONES: Chief Justice Rehnquist, our position is not that it was unreasonable to take this tax position. Our position is that, as Professors Bitker and Eustis said, a lawyer's passion for technical analysis of the statutory language should always be diluted by distrust of a result that appears too good to be true.

We think that this executor, in seeking this tax windfall, should have known and probably did believe that his hoped-for windfall should be diluted by distrust of

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this result.

QUESTION: And why should he have distrusted the result if that were a proper construction of the statute?

MR. JONES: He should look at this as -- as the "Wall Street Journal" article we cited describes it, as a tax maneuver. It might work. On the other hand, it was such a glaring deficiency, it was such -- it was a newsworthy goof in the 1986 Act, and it was reasonable to assume that Congress would promptly amend the statute.

QUESTION: Well, what if we take the view that the language was clear and that it was all right to rely on it until it was corrected? Then what -- what do we look to?

MR. JONES: Well, then you would be -- you would be embarking --

QUESTION: I mean, I think that's a perfectly sensible approach. And then what do we do?

MR. JONES: You would be embarking on a new constitutional approach to these cases. And I think that we really need to focus in on what -- what was the issue that Congress had to address, and what's the constitutional issue for this Court to address?

The court -- the 9th Circuit held that this briefly retroactive amendment violated the due process clause. Under the due process clause, legislation must

not be arbitrary or capricious. It must reflect a genuine exercise of a valid legislative power.

In the Pension Benefit and the General Motors cases, this Court held specifically that retroactive legislation satisfies these due process requirements if there is a -- if the retroactive features of the statute are a rational means of accomplishing a legitimate Government interest.

Now, in the context of --

QUESTION: Are there any -- are there any cases thus far giving any real substance to legitimate Government interest? What if -- what if the Congress came along and said our theory of taxation, based on the assumptions of supply-side economics in the eighties, turned out to be wrong; we lost too much money. So, we want to go back -- let's assume they do it consistently with the statute of limitations at least -- we want to go back and refigure the tax rates for those years to recover money. Does that succeed?

MR. JONES: Well, that's -- that's a question that I don't think that can be answered better than the Court did in Welch v. Henry. What the Court said in Welch v. Henry was, assuming a tax could go so far back to make that objection valid. This is not such a case.

There are solid institutional and practical

reasons why that kind of hypothetical really shouldn't be answered in the abstract. The Court declined to do that in Welch, where -- where the tax was imposed retroactively two years, a 1935 tax --

QUESTION: But Welch -- Welch was a different case from this. The Court observed, as I recall, that the taxpayer would not have changed his conduct. Nothing different would have happened.

MR. JONES: Well, actually, in Welch, Chief Justice Rehnquist, the taxpayer contended that he purchased and held Wisconsin dividend stock in reliance on the economic inducement of the deduction. And what the Court held was that a taxpayer should be prepared for the possibility of a retroactive change in the tax laws.

QUESTION: But didn't the Court also observe the fact that the receipt of income would have gone on regardless of what the statutory provision was?

MR. JONES: I think the -- the Court did make the point that the dividends weren't going to be returned just because taxes were owed on them. But that doesn't really address the fact that what the Court -- that the issue -- an issue in Welch was the taxpayer's claim of reliance on the statute.

QUESTION: Well, if the Court made that observation, you can say it's dicta, but you can argue

that it wouldn't have made that observation if it didn't think it was of some importance.

MR. JONES: Well, what wasn't dicta in -- in -- clearly in Welch was its statement that taxpayers must be prepared for the possibility of retroactive changes, and that there is no injustice in Congress, upon first learning of the effect of the tax, making a retroactive revision.

QUESTION: Then there's no reliance rule ever?

MR. JONES: There is no prior notice rule, and there is no reliance rule, nor is there a detrimental reliance rule or a reasonable reliance rule. The Court of Appeals --

QUESTION: But they -- they were talking about taxpayers generally, and not taxpayers -- it does seem to me that there is something quite different about a provision that is written as an incentive to induce taxpayers to do something that is against their economic interest; namely, in these cases, to sell stock to these employee stock ownership plans, which will be sold at less than what you could get elsewhere, obviously, because the plan knows that it's -- it's buying it from someone who has a real incentive to sell it to them.

Now, you dangle this in front of the taxpayer and say, take a loss in order to get the tax benefit. And

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then, later, you take away the tax benefit. The possibilities are wonderful for achieving all sorts of governmental program. That's quite different from any of these other cases I think.

MR. JONES: Well, it's not really different from Welch, because in Welch, the State of Wisconsin had adopted a -- an incentive for ownership of Wisconsin corporate stock by exempting only Wisconsin dividends from the tax. Frankly, the constitutional justifications for the retroactive revision of the -- of section 2057 are much stronger than they were in Welch. Because, in Welch, Wisconsin had simply changed its law because it decided it wanted more revenues and that this was a good way to do it.

In this case, Congress made the retroactive revision of a tax to avoid a glaring loophole that was a matter of some public discussion, and was designed to avoid misuse of public legislation. And in the words of this Court's opinion in Heinssen and Graham and Goodcell, it was designed to cure a defect in the administration of the tax laws.

QUESTION: Well, what was the purpose of limiting this to stock that was owned previously, just before the death of the decedent?

MR. JONES: The -- the legislative history of

the initial Act had described the fact that what this stock -- what -- what this provision was designed to do was to allow owners of businesses, upon their death, to encourage their estates to sell that ownership stock to the ESOP, and -- and -- so that it wouldn't go out into the public domain. It was an opportunity to solidify the -- the closely held corporate stock into the ESOP.

Now --

QUESTION: So, so, the thought was that this would apply primarily to stock that wasn't publicly traded?

MR. JONES: I -- I think it would be overstating the legislative history to go into that type of detail. I think that what this legislative history reflected was that this was where -- how they thought it would apply.

QUESTION: Well, but if the point of it is to --

MR. JONES: It was designed to keep it out of the public.

QUESTION: -- to encourage employee plans to begin -- to have more ownership of the employer company, then the way the tax statute was drafted really did further that purpose. There's no question about that. I mean, it furthered it so much that the Government began to be terrified by the loss of revenue.

MR. JONES: I really don't think anyone could --

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could suggest that, in adopting this provision, Congress meant it to have its fullest possible reading. No one would really think that what Congress meant to do here was to allow estates to just go out and -- and run a --

QUESTION: Well --

MR. JONES: Sit across the table from an -- from the ESOP and hand stock back and forth until the --

QUESTION: Well, what more do we do other than read the -- read the language that Congress has adopted? Do you -- do you --

MR. JONES: Well --

QUESTION: Are you supposed to read a statute with the idea that, this is a weird provision, ergo, Congress never would have adopted it? Certainly, 24 years of experience here suggest the opposite to me.

MR. JONES: The only reason --

(Laughter.)

MR. JONES: The only reason we even address the issue of the reasonableness of reliance is because the Court of Appeals raised it. This Court has never raised it. In Welch, I suppose one could say that the statute was clear on its face, Wisconsin dividend stock is not subject to tax. But what the Court said is, this is a constitutional question. And under the Constitution, Congress can do things that aren't arbitrary and

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capricious. And there is --

QUESTION: Mr. Jones, that's what I'm trying to determine, is how far you carry that. You have given us so far the "too good to be true" test. If you looked at this and you said, oh, my goodness, I'm going to get two-and-a-half million in the deduction in exchange for a $600,000 loss -- too good to be true.

Suppose, to take this very situation, Congress had said, ESOP's have had it good enough, and we're going to even take away the decedent who owns this share, we're going to take that away six months later and make that retroactive. And let's -- and we have the same constitutional question. The statute had been written originally -- as you say, it should have been all along -- to qualify the decedent must own the share. Two months into the new year, Congress decides it's given away too much. And so, that's one of the things it's going to change retroactively.

Would there be a constitutional problem?

MR. JONES: Well, I think that there would be a constitutional issue. And, again, what this Court has said in several of these cases is that you look to the facts and circumstances of the particular case to determine whether the statute, the amending or repealing or retroactive statute, was a rational means of addressing

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a legitimate Government problem.

QUESTION: Well, was it in that case?

MR. JONES: In which case? In the hypothetical?

QUESTION: The case that Justice Ginsburg just put to you.

MR. JONES: Well, I'm -- I would like to be able to tell you that there is a clear answer to that. In my view, there is a clear answer to that. In my view, it would be no different than Wisconsin retroactively, for two years, repealing their dividend exclusion under State income tax law.

QUESTION: Then isn't the -- isn't the answer simply that you can't seem to think of -- of an example, or maybe we can't seem to think of an example which would ever run afoul of the rule. And the rule that you're arguing for really is that so long as Congress at least has some public purpose in mind, there's no limit on what Congress can do.

MR. JONES: I -- I think that so long as what is -- what Congress has enacted is either within the power to raise and levy taxes, or within the necessary and proper clause under Article I of the Constitution, that that resolves the question of whether this was a rational means of furthering a legitimate public interest.

QUESTION: Which is to say that the retroactive

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feature never, as such, combines with any other set of facts to invalidate the retroactive exercise?

MR. JONES: I would not say that, personally. I don't think --

QUESTION: It seems to me that that's the implication of what you're saying.

MR. JONES: There -- there are two answers to that. And the first is -- is the one I've already mentioned, which is there are good reasons for the Court not to try to answer that question in the abstract.

QUESTION: Yes, but the answer to that is there are good reasons not to adopt a test, the meaning of which we do not understand. And I do not understand the limit of your test.

MR. JONES: Well, the test that I'm proposing, if you will, for the Court to adopt is a test that the Court has adopted in a string of maybe 20 cases in this century in which it has upheld retroactive tax cases as not being arbitrary or capricious.

QUESTION: Even -- even with that pedigree, I still do not understand.

MR. JONES: Right. Well, there -- there is a -- there is a way to think about this that even in describing -- I would not recommend to the Court in an opinion trying to nail down the theory, if you will, on this subject.

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But there is a way to think about this issue, about the limits of retroactivity.

One way would be to say that the power that Congress draws upon is the power to raise and levy taxes, and that a -- the concept of a tax may itself have some substance that avoids an unduly retroactive result. That is to say, there may be some type of contemporaneity within the very concept of a tax to distinguish it from a -- from what the Court described in -- in Unt -- rather in Nichols -- as a taking.

But there is no jurisprudence within this Court's decisions on that subject. And there is a good reason for that. The good reason, it seems to me, is that Congress doesn't go around, willy-nilly, doing these kind of hypothetical things.

QUESTION: That's saying trust Congress to be rational and just. But, reading your presentation, this is what I got out of it. And please correct me if you have a stopping point less than this. You seem to say, deductions are a matter of legislative grace. Congress can retroactively delete any deduction it gives as long as it acts promptly to do so.

MR. JONES: Certainly, if it acts promptly to do so. That's what this Court held in Darusmont in 1982. That's what it held in Welch in 1938.

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QUESTION: So, taking out that they have to act promptly can't be 13 years later? They have to act promptly, but they can be very clear that here's a deduction, and six months later say, we gave away too much and withdraw that same deduction. And that's all right? That seemed to be your position, and I wasn't 100 percent sure that you had a stopping point somewhere short of that.

MR. JONES: There -- the Court hasn't drawn a specific stopping point in terms of how far back you can go. The longest going back that I'm aware of was the Heinssen, where Congress went back eight years to impose a tax on imports that this Court had held there was no authority under the preexisting legislation. The Court held that that was an appropriate exercise. It wasn't arbitrary or capricious; that it was an appropriate exercise of the taxing power to cure a defect in the administration of the tax laws.

The Heinssen rationale certainly would apply here, where the defect was, in our view, palpable, and in view of the -- of public commentators, was palpable as well.

But perhaps I should emphasize once more that I'm not ask -- we're not asking the Court to decide whether -- whether the taxpayer acted reasonably or not.

We're not asking the Court to decide whether the taxpayer really didn't rely whether he was taking a gamble. We're simply meeting -- meeting head-on their argument in that respect. We don't think that's even relevant to the constitutional test that this Court has carefully in several -- in several opinions, articulated.

I should point out again, on an issue that we think is not actually relevant to the decision, the -- the proposition that the taxpayer did detrimentally rely. The Court of Appeals was concerned about the fact that this transaction resulted in a $600,000 loss for the estate. The tax benefit of that loss would be accounted for on the estate's income tax return. It has no relationship to the estate tax return or to the deduction under section 2057, which is calculated simply as 50 percent of the proceeds of the sale, without regard to whether there was a gain or a loss.

Moreover, the loss claimed by the estate in this case resulted primarily from a two-day holding period that the estate employed in an effort to breath economic substance into this tax-motivated transaction. The price fell somewhat in the interim.

QUESTION: For what it's worth, didn't they sell below market even when they sold?

MR. JONES: It -- well, this is a summary

judgment case, and so it's hard to answer questions like that. But the facts shown in the record are that on the final -- on the day of the sale, there was a trading range of I believe $7.12 to $7.40. They sold at $7.05. So, theoretically, there was a discount. But there's no -- there's no testimony from anybody to establish that.

There is evidence in the record that there was no broker's commission paid on this sale. And so, the savings -- the savings at issue may come from that as much from any bargain for a discount.

QUESTION: If they didn't sell below market, I guess the market doesn't work the way everybody thinks it works.

MR. JONES: Well, they --

QUESTION: I mean, I cannot imagine a deal between somebody who knows that he gets a big tax benefit if he -- if he sells it to a particular buyer, and that buyer knows that the seller gets a particular tax benefit, and the buyer comes in and says, hey, I'll give you a market.

MR. JONES: I'm not suggesting --

QUESTION: Human beings just don't operate that way.

MR. JONES: I'm not suggesting there might not have been some discount. But there isn't any evidence

here as to what the discount might have been. There is evidence that no commission was charged on the sale. But our point, as we made it in -- in the brief, and which isn't disputed by Respondent, was that if this stock had been purchased only a couple of days earlier and sold on the same day, the estate would have made an $800,000 gain instead of a $600,000 loss. The claimed deduction would have been the same.

QUESTION: Well, the District Court granted summary judgment for the Government. Then the 9th Circuit reversed it. Did they say -- did they enter judgment for the taxpayer or send it back for a trial?

MR. JONES: They entered judgment on the -- on the stipulated record.

QUESTION: On the -- and was -- did the stipulated record include anything about a sustained loss?

MR. JONES: I think it showed the mathematics that -- of what they paid for the stock and what they got back.

QUESTION: Well, can one fairly determine from that -- those mathematics -- whether there was a loss or not?

MR. JONES: One can determine there was a $631,000 loss. Our --

QUESTION: And those are -- those are stipulated

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facts?

MR. JONES: Yes, sir.

Our point is simply that the -- the -- the primary ingredient to that loss was that the market dropped. They bought at the top of the market. I mean, the bottom --

QUESTION: And it's also stipulated how much the estate tax savings was?

MR. JONES: Yes.

QUESTION: And that was 2.5 million?

MR. JONES: Yes, that's correct.

I mean, our point is statutes shouldn't be unconstitutional if the market goes down and constitutional only if the market goes up. As this Court held in Welch, the taxpayer has no constitutional entitlement to the benefit of the deduction that Congress rationally revised.

QUESTION: But your -- your bottom line is Congress can withdraw a deduction as long as it does so promptly? That's, I take it, the end point --

MR. JONES: Certain -- in our view, certainly, if it does so promptly. I mean, I -- I hate to keep, if you will, beating you with your prec -- your own precedent, but the Heinssen case did apply a tax retroactively for eight years. Was that prompt?

Well, I don't think that promptly is necessarily the only issue. I think it's a complex problem. But the bottom line, the constitutional standard that the Court needs to determine is whether what Congress did was rational or, stated differently, was it arbitrary?

Well, it was clearly rational to try to avoid a misuse of this drafting defect. It wasn't arbitrary or capricious.

QUESTION: Use, why don't we just call it use of a drafting defect, because if Congress had never changed it, never required the shares to be owned by the decedent --

MR. JONES: I call it misuse because, as applied by the executor in this case, it would make all the other provisions of the Federal estate and gift tax super -- superfluous.

QUESTION: Incidentally, why isn't this statute too good to be true even if you read it as later amended? Why isn't it too good to be true for the -- for the -- for the employer who dies with a closely held stock? I mean --

MR. JONES: Precisely for the reason that I think I just mentioned, and that was that it's too good to be true for the -- when the statute really makes the whole tax go away. You can sit down across the table from the

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ESOP and hand paper back and forth all day long until you've got a big enough deduction so you don't have to pay a tax. There was -- there is a case -- I mean, that's exaggerating a little bit, although it's possible under their interpretation of the statute. There is a case a little bit like that before the Court, the Ferman case, which is pending on certiorari, where the executor rotated a $400,000 fund through a broker until she got a big enough deduction to avoid the estate tax.

That's too good to be true. It was rational for Congress to say, we shouldn't let that happen. It was only retroactive for a year. This Court has sustained much more.

QUESTION: Mr. Jones, can I ask you if at any stage in this proceeding, did the IRS take the position that because the whole thing was too good to be true that it should not have been construed literally, but should have been construed, as some of the senators said, what they intended?

MR. JONES: We -- we are logically obstructed in trying to take that technical approach under -- under the -- under this Court's opinions -- from the two-day holding period. That's why the two-day holding period is there, to give economic substance into the transaction. And it was during that two-day holding period that the stock went

down.

QUESTION: No, my question was a simpler one. I was just asking, at any stage in this litigation, did the Government make the argument I just suggested?

MR. JONES: I know that it was addressed in the Court of Appeals. I know that only from the fact, frankly, that the Court of Appeals rejected that suggestion.

QUESTION: Well, then, you must have argued it if they rejected it?

MR. JONES: I assume so. I do not, frankly, recall what was said on that in the District Court. I do not believe the District Court addressed it.

QUESTION: But here you're not trying to make any kind of business purpose test?

MR. JONES: This is a -- this is a due process constitutional case.

QUESTION: But let me -- let me understand that I got your answer right to this. That even if it had been decedent's shares from the beginning, if that had been written into the law, even that, Congress could have withdrawn such a deduction as long as it acted promptly to do so in the next tax year?

MR. JONES: Yes, I think Welch would stand for that proposition.

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I'd like to reserve the balance of my time for rebuttal.

QUESTION: Very well, Mr. Jones.

Mr. Allen, we'll hear from you.

ORAL ARGUMENT OF RUSSELL G. ALLEN

ON BEHALF OF THE RESPONDENT

MR. ALLEN: Mr. Chief Justice, and may it please the Court:

The fundamental issue is the one that the Court has been questioning, and that is, whether there is a due process constraint on the retroactive application of the taxing power. I will suggest that there is a limit; that the case before you is one with very unusual facts, which clearly demonstrate that the limit can be exceeded.

The critical element here is the element of specific inducement.

I will close by addressing the Government's siren song that it was simply too good to be true.

As Justice O'Connor reminded us two years ago in the Romein decision, retroactive legislation presents more serious problems of unfairness than prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions.

And while we don't argue about Congress' broad latitude to enact retroactive legislation as a general

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proposition, it is constrained by due process from enacting arbitrary and irrational legislation. Put another way, retroactive legislation must be supported by a legitimate legislative purpose furthered by a rational means.

QUESTION: May I just interrupt with one question prompted by one of the amicus briefs that talks about procedural due process? Are you making what is a terrible word, a substantive due process argument?

MR. ALLEN: I'm not sure that I understand the distinction, Your Honor.

QUESTION: Between procedural and substantive due process? You really don't know whether you're making a substantive due process argument or not?

MR. ALLEN: As I read the Court's decisions, particularly in the retroactive tax cases, I find myself very confused and the line very fuzzy between what we're talking about. I think I can characterize this in either fashion, and I'm not sure that -- that, from my perspective, the analysis is helped materially by doing so. That's clearly a bugaboo --

QUESTION: That they gave you a 2.5 million deduction and then they took it away sounds pretty substantive to me.

(Laughter.)

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MR. ALLEN: Well, as Your Honor --

QUESTION: It sounds like a pretty bad process, too.

(Laughter.)

QUESTION: Would the Government's case be any stronger -- could it have been strengthened by any different legislative procedure? If they had more hearings and had a lot more witnesses and three or four votes to be sure they got it right, would that make it any different?

MR. ALLEN: I suppose it would depend on at which stage you're asking, Justice Stevens. If the question is, would it have been different had they held more hearings or considered more in the process of deciding in 1987 to amend the statute, I don't think that would make any difference at all.

QUESTION: So then it is a substantive case?

MR. ALLEN: Perhaps so.

QUESTION: Mr. Allen, were you counsel for the taxpayer at the time the income tax return was filed?

MR. ALLEN: Yes, Your Honor.

QUESTION: It's none of my business; did you suggest this deduction or did the taxpayer say he wanted it?

MR. ALLEN: The estate tax deduction I believe

was the taxpayer's question to me in the first instance.

QUESTION: Mr. Allen, the -- whether this is substantive due process or procedural due process, either way, you're saying that there is something that's under the due process clause, which rather duplicates what's in the ex post facto clause. Now, we have another provision in the Constitution that prevents ex post facto laws. That's been interpreted to apply only to criminal and penal laws.

Wouldn't you think that if there was a guarantee against retroactivity generally it would have been -- would have been put in that provision rather than in -- it seems to me, you know, inclusio unius est exclusio alterius, since we only prohibit criminal and penal ex post facto, the implication is that retroactive laws or whatever else they may be, are not unconstitutional. And there were -- there were State -- State constitutional provisions. We had one in a case before us a few weeks ago, that did pro -- prohibit retrospective legislation generally, but we chose not to do that in the Constitution.

MR. ALLEN: I believe that, as a general proposition, you're correct; that we do not have that sort of blanket. On the other hand, we have very clear precedent from this Court for the last 200 years that, in

some instances, retroactive legislation does violate due process. And there's nothing special about tax legislation. We use a slightly different rubric there. But whether you -- you look at the language from Turner Elkhorn or Gray on the one hand, or Hemme and Welch on the other, we recognize that sometimes the Congress goes too far in changing the tax law retroactively.

We say that it cannot change the law in an unduly harsh and oppressive way, considering the nature of the tax and the circumstance in which it's --

QUESTION: But is that a criterion or is that a conclusion? I mean, if we concluded, for example, that in fact there was no legitimate purpose to be served, or there was no rational relationship between the act and the legitimate purpose the Government claimed, wouldn't we, in effect, embody that conclusion by saying, yes, it was unduly harsh and so on?

I'm not sure that that gives us a test, rather than it -- so much as it simply expresses a conclusion.

MR. ALLEN: I submit, Your Honor, that it depends on your focus. I believe that under the due process jurisprudence we focus both on the taxpayer and on the purpose of the Government. In the latter case, the purpose of the Government, it may simply be an explanation and not a test. In the former, when we are looking at the

arbitrariness of the retroactive change, there we're focusing on the taxpayer. And there I believe harsh and oppressive does become a test in and of itself.

The retroactive application here is arbitrary. It's arbitrary as defined by Justice Stone in the Welch case, when he summarized the series of cases that had been decided over the prior decade. He found in those cases a unifying theme, that where the taxpayer could not reasonably have anticipated that he or she might be taxed as a result of a transaction --

QUESTION: Mr. Allen, who are the beneficiaries of this estate?

MR. ALLEN: The beneficiaries are the four children of Willametta Day, Your Honor.

QUESTION: Let me ask another unfair question. You of course expect to win this case. Suppose you don't, is there a possible liability on the part of the executor?

MR. ALLEN: It seems to me that but for the specific inducement of this statute, the executor would have committed a very clear breach of trust, by selling off the market and below market value. Given the specific inducement of this statute, I think it would be difficult for the beneficiaries to challenge the reasonableness of the executor's activity.

QUESTION: I suppose if the Government had been

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decent about the thing in its retroactive curative legislation it would have at least allowed a credit for any loss that had been taken.

MR. ALLEN: You might say that, Your Honor, but I certainly couldn't.

(Laughter.)

QUESTION: And what -- what you say -- what you say about -- about evaluating the harshness and oppressiveness leads me to believe that you think this statute may be invalid as to some taxpayers and valid as to others, depending upon how harshly and oppressively its impact is felt. Is that a fair characterization of your --

MR. ALLEN: Yes, Your Honor. Yes.

QUESTION: And you say $600,000 is harsh and oppressive?

MR. ALLEN: I would not define it in $600,000 as much as I would in the circumstances of the case taken as a whole. Here we --

QUESTION: But if -- the $600,000 is balanced against -- to the extent of this -- having your estate tax, that's a rather -- one of the questions that puzzled me is there was -- this was a rather large estate, and yet you did this with a relatively small piece of it. Why didn't you go further, given the opportunity to have your

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estate tax?

MR. ALLEN: Well, it isn't always easy to do as much as one might hypothetically want to do. There's a practical limit, particularly in this case. The President signed the bill on October 22nd. Congress adjourned a bit after that. Mrs. Day's return, even on extension, was due December 29th. There are some practical limits in how much stock you could afford to buy without doing the sort of churning that Mr. Jones suggests some might. There is a practical limit to how much you can afford to buy. There's a practical limit to how much an ESOP may want to purchase -- or ESOP's may want to purchase.

So, you're quite correct that the taxpayer here, even under our view of the law, paid $18-and-a-half million in estate tax. This isn't a case of --

QUESTION: But if you had found a few more ESOP's you could have -- and if you prevail, you could have made that tax bill very much lower?

MR. ALLEN: At least in theory we certainly could have, Your Honor. In practice it might not have been quite so easy.

QUESTION: And Justice Scalia asked you a question before -- I mean, to get such an advantage, it seems that $600,000 really wasn't a whole lot -- wasn't a very large loss. I was wondering why there was -- wasn't

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even more of a differential in the price, considering what the ESOP -- what advantage you were gaining as a result of selling to this ESOP.

MR. ALLEN: The amount of the discount was determined in bargaining between the executor and a representative of the ESOP after the stock had been acquired. That led to a sharing of roughly 80/20, with the ESOP getting about a half-million dollars more stock than it otherwise could have purchased.

Just as in the old --

QUESTION: Excuse me. Sharing 80/20 means sharing what, the tax benefits 80/20?

MR. ALLEN: That's correct, Justice Scalia.

The ESOP was able to purchase a half-million dollars more stock than it otherwise could have. If you look at the income tax exclusion for banks, under section 133, that make loans to ESOP's to buy stock, that provision allows the bank to negotiate the interest rate. And if you look at -- I believe it's -- footnote eight of the joint committee study that the Government cites in its brief, it reflects that an industry pattern at the time of perhaps an interest rate 80 percent of prime or 80 percent of what otherwise would have been charged in that context.

In the context of the old estate tax provision that allowed an ESOP to assume estate tax liability as

part of an ESOP purchase, there was no particular requirement of a discount or any particular sharing. And the same is true under the income tax deferral provision for closely held stockholders who sell to ESOP's.

So, in this case, the negotiation led us to about a half-million dollars more stock to the ESOP than it otherwise could have purchased. But there was nothing in the statute that said one way or another how much was appropriate or reasonable.

QUESTION: Given -- given the rather significant estate tax advantage, do you disagree with the characterization, looking at this provision, this is too good to be true, it's too good to last?

MR. ALLEN: It seems to me that there are two problems with the Government's "too good to be true" argument. One is a -- one is a factual problem and the other is an analytic one. On a factual basis, there simply is nothing there to support the Government's argument in this case. The President signed the bill. The Congress amended the bill several times before it adjourned. The Congress considered several hundred other technical corrections that it didn't enact, one of which specifically dealt with this section, and proposed to delete --

QUESTION: Too good to be true in the sense of

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-- of the tremendous estate tax savings that was involved.

MR. ALLEN: But as one of the questions directed to the Solicitor General noted, we -- the "too good to be true" doesn't reflect anything in the economics of the transaction. If Mrs. Day had been an investor in MCI on the day it was incorporated, or if indeed she had bought the stock on her deathbed, we wouldn't be here. And there's no reason to believe the transaction would have been any different or the economic positions of the parties.

QUESTION: Then you would have a rather circumscribed group. This would be open to everybody. You want to come in and lower your estate tax, here's a great way to do it.

MR. ALLEN: That's right. If you want to get more stock in the hands of ESOP's, this is a great way to motivate people to do that. And it seems to me that, from an analytic perspective, we have a tremendous difficulty in telling when something is too good to be true, when it is intended, just before Russell Long retires, as opposed to when it was a mistake according to the leaders of the next Congress, a week after he retired.

QUESTION: So, you're saying that there is nothing in the record from which we could either conclude or take judicial notice that most practitioners would be

on notice that this statute was likely to be amended?

MR. ALLEN: At the time the executor made this sale, that is exactly true, Your Honor.

QUESTION: And I don't mean amended retroactively, amended at all.

MR. ALLEN: I think that is true, Your Honor. At the time this took place, the Government signed the bill on October 22nd. Congress considered some amendments. They passed a couple. They considered a lot more. They adjourned. The executor engaged in this transaction. Three --

QUESTION: But you don't disagree that if had stayed on the books, then every estate that could would have tried to make this kind of transaction, I guess, or --

MR. ALLEN: We might have ended up with a lot more stock in the hands of ESOP's.

Three weeks --

QUESTION: Mr. Allen.

MR. ALLEN: Yes, Your Honor.

QUESTION: Taking the concept of a clerical error on one side, that everybody can see that Congress meant to write a law that said 5 percent, and by mistake 10 percent was printed, and on the other side, a mistaken judgment on the part of Congress, where Congress enacts a

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tax benefit law and later decides this is just killing our revenue, do you think there is room for any kind of "too good to be true" concept in between those two concepts?

MR. ALLEN: There may well be, Your Honor. It seems to me that if there were a very clear and distinct conflict between the legislative history and the language of the statute, there may be room for that kind of argument.

If the executive branch or if the Congress has under public consideration a proposal to change, there may be a "too good to be true" kind of notion. But here, the executor acted three weeks -- two-and-a-half weeks before the Wall Street Journal article that the Government cites in its reply brief for the first time, and this morning; three weeks -- one more week -- before the Internal Revenue Service's first hint of a proposed change or suggestion of a mistake; four months before the legislation was introduced to cure the problem; and 14 months before the legislation was passed.

Now, you can go further down the line and say, maybe at some point somebody should have said, we cannot reasonably anticipate the end result of this transaction. But you have to remember that the facts in this case arose several weeks before any of that took place. And it took place --

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QUESTION: So, is there anything in this record or in documents from which we can take public notice that would indicate that a member of the bar would be on notice that this was likely to be repealed, and repealed retroactively?

MR. ALLEN: I know of nothing in the record in this case for which this Court can take judicial notice at this time -- I know of nothing at this time, as of the time that the executor acted in this case.

QUESTION: Other than perhaps our assessment that it's too good to be true?

MR. ALLEN: With due respect, Your Honor.

Too good to be true has these factual problems that we've been talking about and that are talked at length in the brief. But it has --

QUESTION: Part of a measure with -- rather, the Long measure of this provision came up in -- in the bill that had how much in it?

MR. ALLEN: This provision was part of the Tax Reform Act of 1986, which was a major piece of tax legislation. It may be worthwhile to note that at Senator Long's request this provision, as a group of a small provisions dealing with ESOP's, was subject to a separate vote, which, in the Senate, was 99-0.

There's an analytic problem with this "too good

to be true," besides the factual problem. To use the classical illusion, it is a siren song. It would lure the Court onto the rocks of second-guessing the Congress. When is something a mistake, as opposed to a change in policy? How do we know when it's too good to be true?

If we take the Government's argument in its reply brief literally, then the taxpayer and this Court should engage in an economic analysis to compare the benefits of this ESOP subsidy with other ESOP subsidies and say that this one is much greater congressional largesse, to use their term.

QUESTION: The Government, in fact, didn't make that argument. It said that any deduction can be withdrawn as long as it's done so promptly.

MR. ALLEN: I believe, Your Honor, it also, in its reply brief, argues, at footnotes eight and nine, that this was too good to be true because of the magnitude of Government largesse.

It's not easy to tell what the economic benefit of a tax subsidy or a tax expenditure provision is. For example, in this case, in the 9th Circuit, Judge Norris made a fundamental flaw in his analysis that the Government has picked up and repeated in its reply brief. If a bank otherwise would make a loan at a 10 percent interest rate, and loans a dollar to an ESOP to buy stock,

the bank excludes half the interest income from its interest income reported on its income tax return, the FISC has lost five cents of the tax base. That's true.

But the ESOP is not better off by a dollar as suggested in Judge Norris' opinion, or in the brief. The ESOP still has to pay the dollar back to the bank. It's only better off by the interest savings over the life of the loan, which allows it to buy a little more stock.

Going through this is not easy stuff. I suggest that to determine the cost to the FISC you have to look at the marginal tax rate of the selling shareholder, or the loaning bank, you need to look at the discount rate to be applied to future payments to discount them back to present value, you need to think about the amount of the bargain in either the sales price or the interest rate. In some cases, you need to think about the capital structure of the employer.

This may be a worthwhile exercise for the joint committee staff, or some Ph.D. candidate in finance with some elaborate computer models, but it's not something that counsel or the Court, I respectfully suggest, is in a position to assess.

It leads the Court, if it adopts the Government's rationale --

QUESTION: Mr. Allen, you're very persuasive on

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all the pitfalls here. Is your -- is your argument confined to estate taxes, or do you make the same argument, say, on income tax on capital gains, for example? I'm just thinking, you say an easy case, that the Congress decided that their revenue needs were such that they would charge -- tax capital gains during the closed years, say two or three years back, at 35 percent instead of 25 percent. Would that be unconstitutional?

I take it, it would be under your --

MR. ALLEN: I don't believe that our analysis necessarily goes that far, Justice Stevens.

QUESTION: I'm assuming no windfall, no notice of anything, just the Government needs a little more money. But you don't think that would be unconstitutional?

MR. ALLEN: Well, I'm not sure. I think there is a temporal element here of how back -- far back one can go.

QUESTION: Assume it goes back no more than two or three years.

MR. ALLEN: And I also think there is a question of prior history. The Government is obviously reading something different in Welch than I am. I've read the Welch briefs. And I've read that opinion more than once. And it seems to me very clear that the taxpayer did not

make a detrimental reliance in Welch. The Government never -- the taxpayer there never said, I wouldn't have invested in Wisconsin corporations. In fact, he couldn't have said that.

The introduction to Justice Stone's description of the facts in that case goes through the history of Wisconsin having three different means of providing preferential benefits for in-state dividends. It already changed it several times. And for the taxpayer in Welch to have said, I wouldn't have invested in 1933 in Wisconsin dividends because I couldn't possibly have foreseen a change. I mean, the taxpayer couldn't have made that argument and in fact didn't in any of the briefs.

What Welch is --

QUESTION: But, see, the thrust of my question is, is the detrimental reliance that you have in this case really anything different than the ordinary investor faces in -- in buying and selling stocks -- if the tax rates are 25 percent on capital gains, then, two years later, the Government changes the rules on them? It seems awfully unfair, I can see, but is it unconstitutional?

MR. ALLEN: I don't think so, Your Honor. I think we have a good deal of jurisprudence that tells us it isn't. And I think the fundamental difference is

inherent in the economics. Income and deductions, gain, loss, at the beginning of the year affects the tax liability for the year, just as much as what happened in January and February.

In a multiyear transaction of the kind you posit, that may involve multiyear taxation of capital gains, depreciation deductions and tangible drilling costs, whatever, the taxpayer, going in, knows that we're talking about an extended period of time, and that there are economic factors, there are potential legislative factors --

QUESTION: I didn't understand Justice Stevens' question as being related to a multiyear transaction. I thought it was that a transaction had simply been closed and expected to be closed simply on a calendar-year basis, and then Congress goes back two or three calendar years.

MR. ALLEN: Perhaps I misunderstood the question. I thought it was multiyear.

QUESTION: Of course, it's multiyear in the sense that he made the purchase earlier. But he makes a decision to sell in a particular year at a time when the capital gains tax rate is, say, 25 percent. Then, two years later, Congress decides we need revenue and we're going to retroactively tax capital gains for the last three years at 35 percent. That's the case. It seems to

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me that's the same as your case.

MR. ALLEN: I beg your pardon, Your Honor. I misunderstood your hypothetical slightly.

I think it is a somewhat different case than this one, because at the time the taxpayer enters into the transaction, the taxpayer expects to be taxed. The taxpayer expects -- this is a Milliken case, if you will, out of 1931 -- the taxpayer expects that I'm going to be paying capital gains taxes.

The Congress can go back later and say, well, we're going to change the rate, we're going to move it up, we're going to move it down, we're going to change the way we compute the alternative minimum tax. This is not the inducement case. This is not the case where, instead of a revenue --

QUESTION: Yes, but your -- your client expected to pay estate taxes, he just didn't expect to pay quite as much -- quite as high a tax.

MR. ALLEN: No --

QUESTION: I mean, he -- he -- this is not going to eliminate the tax, it's just going to change the amount of the tax.

MR. ALLEN: I think there is a fundamental difference, Your Honor. Here, when Mrs. Day died, we might have expected to pay $20 million in estate tax.

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And, in fact, if you look at the stipulated record, we made an estimated payment of $20 million. Between the time she died and the time the return was due and the tax was finally determined, the Congress enacted a tax subsidy, a tax expenditure statute. This wasn't a revenue-raising statute. This statute, from the get-go, was intended to cost the FISC money.

And what the Government has said, in amending it twice, is, oops, it's going to cost us more money than we thought it was going to cost us. We're not changing a statute that is enacting a tax from people, and that people expect to pay, we're promising them a benefit, and then saying --

QUESTION: Well, but I suppose the closer example for me then would be a statute in 1989 repealing the capital gains tax entirely, and then, two years later, the new administration comes in and said, gee, they made a mistake, so we're going to reimpose the tax. That would be analogous I suppose.

MR. ALLEN: There, it seems to me, you have a very different kind of motivational problem. Would the taxpayer have done it absent this? Would the taxpayer not?

Here, as we noted, when the Government was arguing, there is no rational explanation. There could be

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no conceivable motivation for an executor to commit what otherwise would be a clear breach of trust, but for this inducement, this promise of a benefit.

QUESTION: But it wouldn't, conceivably, under Justice Stevens' hypothetical. If the capital gains tax is repealed, everybody rushes to realize their capital gains in 1989. And then, they learn in 1991 that it's all off.

MR. ALLEN: Well, it seems to me the problem, Your Honor, is that it's very difficult to tell, once we give in to the question of what motivated them to do something. This case is an extreme one. And we don't have to reach those hard questions. There is no question here about why the executor did what he did. It doesn't get fuzzy. It doesn't get murky. It isn't hard.

The taxpayer here doesn't contend that all retroactive legislation, all retroactive tax legislation is unconstitutional. We have no argument with that.

QUESTION: You mean -- are you making a distinction between you did it simply to get -- to take advantage of -- of lowering your estate tax by 50 percent to the extent of this, and other people may have mixed motives; they're doing it both to lower their tax and for some other economic reason, therefore your case should be more sympathetic? That seems to be what you were just

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presenting.

MR. ALLEN: What I'm --

QUESTION: That other people have a business purpose, you have no business purpose other than to save this tax.

MR. ALLEN: No executor would sell at a below-market price, off the market, except to take advantage of the estate tax deduction promised.

QUESTION: So, your motive is pure, it's simply to save tax. Somebody who's doing it for saving tax plus an economic motive is less sympathetically situated, I take it --

MR. ALLEN: I'm suggesting that becomes analytically much more difficult and much more complicated. Here, where we have a clear inducement, it seems to me that there is a limit to the due process clause. We're clearly over that line in this case.

The distinguishing factors here are the lack of any basis whatsoever to anticipate the imposition of the decedent ownership and plan allocation requirements -- clear reliance by the taxpayer, no other conceivable explanation at all, a half-million dollars worth of injury, the specific inducement that the Government now seeks to use to mousetrap the taxpayer.

This case, and the Government's argument here,

goes far beyond any of the Court's existing case law.

Thank you.

QUESTION: Thank you, Mr. Allen.

Mr. Jones, you have three minutes remaining.

REBUTTAL ARGUMENT OF KENT L. JONES

ON BEHALF OF PETITIONERS

MR. JONES: Thank you.

The phrase, too good to be true, has nothing to do with the Constitution or the issue that the Court needs to decide. I want to emphasize one more time, we raise that point only in suggesting that the equitable rationale of the Court of Appeals really doesn't hold water.

The constitutional issue that this Court has clearly articulated is whether this retroactive amendment is a rational means of accomplishing a legitimate purpose.

QUESTION: I would be curious, Mr. Jones, as to how you would answer the question posed by Justice Blackmun: Do you think the executor here would be liable for fiduciary breach?

MR. JONES: I would have to admit that the fiduciary duties of executors is something with which I am not wholly familiar.

QUESTION: Well --

MR. JONES: I'm not sure I could offer an opinion on that.

QUESTION: Let -- let me advise you that it's a breach of due care. Would the executor have been unreasonable in taking the action that it did here?

MR. JONES: I think the executor took a calculated risk. I think it's quite obvious that this was a tax-motivated transaction, that he designed it in a fashion to try to fit within the -- the business purpose rule of this Court's decisions.

Whether his motivation --

QUESTION: I'm sorry, I'm not following this. The taxpayer said we did it to take advantage of the tax loophole -- call it whatever you will --

MR. JONES: Right.

QUESTION: They didn't try to present any business purpose. I think they were very candid in saying, unlike some other people who had mixed motives, our motives was to save the tax.

MR. JONES: The business purpose is the wrong word. They say they took an economic risk in holding this. They had a two-day holding period for the stock. If they hadn't had that, they wouldn't have even gotten past the Gregory v. Helvering business purpose or economic substance standard.

QUESTION: Mr. Jones, I assume that the beneficiaries of the estate were parties to this decision

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in a sense of being advised as to --

MR. JONES: The record certainly doesn't tell us. The executor is -- is here, Mr. Carlton, he's a member of the law firm that -- that is before the Court today.

QUESTION: Well, for what it's worth, I suppose we shouldn't be offering opinions on irrelevant subjects, but I certainly don't think that it would be a breach of the executor's duty, given the state of the law at the time they acted.

MR. JONES: I -- my --

QUESTION: I don't think that's any part of your case.

MR. JONES: It --

QUESTION: Certainly not if he wins the case.

MR. JONES: It's not my case.

QUESTION: Certainly not if he wins the --

QUESTION: But even if he loses is what I'm saying -- even if he loses.

MR. JONES: I don't -- I certainly wouldn't dispute that. In fact, I tried to make the point earlier that we didn't --

QUESTION: The point is, is that it's reasonable.

MR. JONES: We didn't think that he was acting

unreasonably, we just --

CHIEF JUSTICE REHNQUIST: Your time has expired, Mr. Jones. The case is submitted.

MR. JONES: Thank you.

(Whereupon, at 3:02 p.m., the case in the above-entitled matter was submitted.)

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BY Ann Marie Federico

(REPORTER)